



## STATE BOARD OF EQUALIZATION STAFF LEGISLATIVE BILL ANALYSIS

Date Amended:	06/25/02	Bill No:	AB 428
Tax:	Cigarette and Tobacco Products	Author:	Committee on Budget
Board Position:		Related Bills:	AB 433 (Assembly Budget Committee) SB 1849 (Senate Budget and Fiscal Review Committee) SB 1890 (Ortiz)

### BILL SUMMARY

This is a budget trailer bill implementing various provisions incorporated into the 2002-03 Budget. This bill would, among other things, impose an additional excise tax on cigarettes of two and one-half cents (\$0.025) per cigarette, or 50 cents per package of 20, and impose an equivalent compensating floor stock tax, operative September 1, 2002. The revenue from the tax increase would be deposited into the General Fund.

### ANALYSIS

#### Current Law

Pursuant to Revenue and Taxation Code Section 30101 (Cigarette and Tobacco Products Tax Law), an excise tax of 6 mills (or 12 cents per package of 20) is imposed on each cigarette distributed. In addition, Sections 30123 and 30131.2 impose a surtax of 12 1/2 mills (25 cents per package of 20) and 25 mills (50 cents per package of 20), respectively, on each cigarette distributed. The current total tax on cigarettes is 43 1/2 mills per cigarette (87 cents per package of 20).

Sections 30123 and 30131.2 also impose a surcharge on tobacco products at a rate to be annually determined by the Board. The tobacco products tax rate is equivalent to the combined rate of tax on cigarettes and based on the March 1 wholesale cost of cigarettes. Currently, the surcharge rate for fiscal year 2002-03 is 48.89 percent.

Of the 87 cent excise tax imposed on a package of 20 cigarettes, 2 cents is deposited into the Breast Cancer Fund, 10 cents into the General Fund, 25 cents into the Cigarette and Tobacco Products Surtax Fund, and 50 cents into the California Children and Families First Trust Fund (CCFF Trust Fund). The tobacco products surtax imposed under Section 30123 is deposited into the Cigarette and Tobacco Products Surtax Fund, while the surtax imposed under Section 30131.2 is deposited into the CCFF Trust Fund.

#### Proposed Law

Among other things, this bill would add Article 4 (commencing with Section 30132) to Chapter 2 of Part 13 of Division 2 of the Revenue and Taxation Code to impose an

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additional tax of 50 cents per package of 20 cigarettes. The tax would be imposed beginning September 1, 2002. The bill would also impose a compensating floor stock tax on the September 1, 2002 cigarette inventory of a dealer, wholesaler and distributor.

The proceeds from the tax increase would be deposited by the Board into the General Fund.

### Background

Proposition 99, passed on the November 1988 ballot, effective January 1, 1989, imposed a surtax of 25 cents per package of 20 cigarettes, and also created an equivalent tax on tobacco products. Proceeds from the taxes fund health education, disease research, hospital care, fire prevention, and environmental conservation.

Assembly Bill 478 (Ch. 660, 1993) and Assembly Bill 2055 (Ch. 661, 1993), effective January 1, 1994, added an excise tax of 2 cents per package of 20 cigarettes for breast cancer research and early detection services.

Proposition 10, passed November 3, 1998, effective January 1, 1999, imposed an additional surtax of 50 cents per package of 20 cigarettes. Additionally, the measure imposed an additional excise tax on the distribution of tobacco products equivalent to the additional cigarette tax, and imposed an equivalent compensating floor stock tax. The revenues from the additional tax are deposited into the CCFF Trust Fund and are used to: (1) fund early childhood development programs, and (2) offset any revenue losses to certain Proposition 99 Programs as a result of the additional tax imposed by Proposition 10.

### COMMENTS

1. **Sponsor and purpose.** This bill is sponsored by the author and is intended to address, in part, the projected 2002-03 Budget shortfall.
2. **This measure does not contain a corresponding tax increase on tobacco products.** However, the 50-cent cigarette tax increase would increase the tobacco products tax rate for fiscal year 2003-04 as a result of Proposition 99. Section 30123(b) (Proposition 99) generally provides that the tobacco products tax rate is determined annually by the Board, which is equivalent to the combined rate of tax imposed on cigarettes. As such, a tax increase on tobacco products is automatically triggered whenever the tax imposed on cigarettes is increased.

However, an increase to the tobacco products tax rate as a result of this bill would not be effective until the 2003-04 fiscal year because current law provides that the Board determine a tobacco products rate "annually." Since the Board determined the rate for the 2002-03 fiscal year on May 7, 2002 and that rate is currently in effect, a new rate will not be determined until 2003, which would be effective for the 2003-04 fiscal year.

It should be noted that the proceeds from the resulting tobacco products tax increase would not be deposited into the General Fund. The proceeds would be deposited into the Cigarette and Tobacco Products Surtax Fund (created by Proposition 99) to fund health education, disease research, hospital care, fire prevention, and environmental conservation.

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3. **This measure would increase state and local sales and use tax revenues.** Under current Sales and Use Tax Law, the total amount of the sale is subject to sales or use tax unless specifically exempted or excluded by law. Because excise taxes on cigarette and tobacco products are not specifically exempted or excluded, they are included in the total amount of the sale and subject to sales or use tax. Since this measure increases the excise tax on cigarettes, the amount of the sale of these products to which the sales or use tax applies would also increase. The impact this bill would have on state and local sales and use tax revenues is discussed in the Revenue Estimate.
4. **This bill contains floor stock tax provisions.** Proposed Section 30135 contains language to impose a floor stock tax on a dealer's, wholesaler's and distributor's inventory. A floor stock tax is important because it equalizes the excise tax paid by cigarette dealers, wholesalers, or distributors on their inventory and those cigarettes purchased after the effective date of a tax increase. Having a large cigarette inventory before a tax rate increase takes effect can result in a windfall profit to a cigarette seller. The selling price of cigarettes can be raised and attributed to the rate increase, but the additional funds collected are profit and not an excise tax paid to the state. A floor stock tax mitigates this windfall.

As an example of the impact of not having a floor stock tax, in apparent anticipation of the tax increase of 2 cents per package of 20 cigarettes for funding breast cancer research projects beginning in January 1, 1994, sales of cigarette stamps jumped by \$34.8 million in December 1993, or enough stamps for 99 million packs of cigarettes. There was a corresponding decrease in the number of stamps purchased in January and February 1994. Because distributors had an adequate inventory of 35-cent cigarette stamps on hand to affix to their cigarette packages, they could delay for months having to buy the 37-cent stamps which were sold beginning January 1, 1994. This huge inventory stockpiling translated into \$2 million in lost revenue for the Breast Cancer Fund, money which had been anticipated as part of the original revenue estimate.

While there are additional costs associated with administering the floor stock tax, the revenue substantially compensates for that cost.

5. **Would an increase in the cigarette tax increase evasion?** Tax evasion is one of the major areas that can reduce state revenues from cigarettes and tobacco products. In 1999, Board staff spent considerable time developing a variety of statistical approaches to estimate cigarette tax evasion. In addition, Board staff reviewed numerous studies of behavioral responses of smokers to price changes as well as studies that estimated tax evasion. Using a baseline statistical model, Board staff estimated that cigarette tax evasion in California was running at annual rates of approximately \$130 to \$270 million. The estimate was only for evasion of excise taxes, and did not include associated evasion of other taxes, such as sales and use or income taxes. A key premise in the Board's research is that both cigarette consumption and cigarette tax evasion are highly correlated to product prices and excise tax rates.

Two major events that occurred since November 1998 have dramatically increased California excise taxes as well as cigarette prices excluding taxes: Proposition 10 and the Tobacco Master Settlement Agreement made between states and tobacco

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manufacturers (tobacco settlement). Together, these two developments, when coupled with typical wholesaler and retailer distribution margins, have increased average prices of cigarettes to California consumers by about 50 percent in relation to early November 1998 prices. It was estimated that the impacts of Proposition 10 and the tobacco settlement more than doubled cigarette tax evasion in California.

This bill would impose an additional excise tax on cigarettes of 25 mills per cigarette, or 50 cents per package of 20, and impose an additional excise tax on the distribution of tobacco products equivalent to the additional cigarette tax. It is assumed that this increase would cause a correlated increase in tax evasion based on the Board's findings when developing the impacts of Proposition 10 and the tobacco settlement. The Revenue Estimate discusses the impact this bill would have on excise tax revenues associated with tax evasion.

6. **This bill reduces the floor stock tax by the distributor's discount.** Current law provides that stamps and meter impression settings shall be sold at their denominated values less 0.85 percent to licensed distributors. The discount is intended to help defray the cost (leasing of equipment/labor cost) to the distributor for affixing the stamps. As such, this bill would specifically provide distributors with that same discount for purposes of the floor stock tax.

This bill would reduce the floor stock tax paid by a "discount to a licensed distributor determined in accordance with Section 30166." It should be noted that SB 1700 (Peace) and AB 1666 (Horton) would repeal Section 30166 of the Revenue and Taxation Code, thereby eliminating the 0.85 percent distributor's discount. Accordingly, if SB 1700 or AB 1666 becomes law on or before the effective date of this cigarette tax increase, a distributor would not be allowed the 0.85 percent discount for purposes of the floor stock tax.

7. **Suggested technical amendment.** On page 15, lines 29 through 31, the language is unnecessary. The language provides that the tax imposed shall be imposed on cigarettes in the possession or under the control of every dealer and distributor on and after 12:01 a.m. on September 1, 2002. Since this language duplicates the language contained in Section 30135, it is suggested that Section 30133(b) be stricken from the bill.
8. **Related Legislation.** This bill contains identical cigarette tax increase language as SB 1849 (Senate Budget and Fiscal Review Committee). Similar language is also contained in AB 433 (Assembly Budget Committee), however that bill would impose an additional 63 cent excise tax on a package of cigarettes.

In addition, Senate Bill 1890 (Ortiz) would impose, among other things, an additional excise tax on cigarettes of 65 cents per package of 20 and an additional excise tax on the distribution of tobacco products equivalent to the additional cigarette tax. The revenue from the tax increase would be deposited into the Tobacco Use Reduction and Compensation Fund, as created by SB 1890. That bill was held in the Senate Revenue and Taxation Committee. The Board's position on SB 1890 is neutral.

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**COST ESTIMATE**

The Board would incur costs related to this measure for notifying potential feepayers, developing returns, computer programming, developing and carrying out compliance and audit efforts to ensure proper reporting, and administering a floor stock tax.

<u>2002-03</u>	<u>2003-04</u>	<u>2004-05</u>	<u>2005-06 and Ongoing</u>
\$1,073,000	\$990,000	\$533,000	\$507,000

**REVENUE ESTIMATE****REVENUE ESTIMATE****Background, Methodology, and Assumptions****Fiscal Year 2002-03**

**Cigarette Tax.** Tax-paid cigarette distributions were 1,288 million packs in fiscal year 2000-01, down about 5 percent from 1999-00. According to the 2002-03 *Governor's Budget Summary*, total cigarette consumption is estimated to decline in the range of 3 percent annually in the next few years. Consumption is estimated to be 1,212 million packs in fiscal year 2002-03, (1,288 million packs x 0.97 x 0.97 = 1,212 million packs) Consumption for the period September 1, 2002 through June 30, 2003 is estimated to be 1,010 million packs ((10/12) x 1212 = 1,010). However, an increase in the tax rate as large as the one proposed by this bill would surely cause both a decrease in actual consumption and an increase in tax evasion. Although the exact magnitude of the effects is uncertain, we have assumed that this bill would cause an additional decrease of 6.3 percent in tax paid distributions. (This estimate assumes a price elasticity of demand of -0.50, applied to estimated average 2001 prices of approximately \$4.00 per pack.) Therefore, the estimated taxable distributions subject to this proposal for the period September 1, 2002 through June 30, 2003 would be 946 million packs. (1,010 million packs x 0.937 = 946.4 million packs).

The current tax rate on cigarettes is \$0.87 per pack. Under the proposal, this rate would only apply in July and August of 2002. An estimated 202 million packs would be taxed at the current tax rate of \$0.87 per pack in fiscal year 2002-03 (1,212 x (2/12) = 202). A 50 cents per pack increase, starting September 1, 2002 would result in increased excise tax revenues for fiscal year 2002-03 as follows:

	<u>Packs</u> <u>(millions)</u>	<u>Rate</u> <u>(per pack)</u>	<u>Revenue</u> <u>(millions)</u>
Current Rate (July, August)	202	\$0.87	\$ 175.7
Proposed Rate (September through June)	946	\$1.37	<u>\$1,296.0</u>
Total, Combined Rates	1,148	n.a.	\$1,471.7
Current-Law Rate	1,212	\$0.87	<u>\$1,054.4</u>
Difference			\$417.3

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A corresponding floor stock tax, assuming a three weeks supply of cigarettes, approximately 66 million packs ( $((1,212 \times 0.937) / 52) \times 3 = 65.5$ ), would produce \$33.0 million in additional revenue (66 million packs  $\times$  \$0.50 = \$33.0 million).

**Tobacco Products Tax.** The Board of Equalization has set the tobacco products tax rate for fiscal year 2002-03. The proposed \$0.50 per pack increase in the cigarette excise tax rate will not affect the tobacco products tax rate until fiscal year 2003-04.

### Fiscal Year 2003-04

**Cigarette Tax.** As mentioned earlier, under current law cigarette consumption is estimated to be 1,212 million packs in fiscal year 2002-03. Under current law, tax-paid cigarette sales in 2003-04 would be 3 percent below sales in 2002-03, or 1,176 million packs ( $1,212 \times 0.97 = 1,175.6$ ). The \$0.50 tax increase would result in an 6.3 percent decline. This implies fiscal year 2003-04 sales of 1,102 million packs ( $0.937 \times 1176 = 1,101.9$ ).

A 50-cents per pack increase would result in increased cigarette tax revenues for fiscal year 2003-04 as follows:

	Packs (millions)	Rate (per pack)	Revenue (millions)
Proposed Rate	1,102	\$1.37	\$1,509.7
Current Rate	1,176	\$0.87	\$1,023.1
Difference			\$486.6

**Tobacco Products Tax.** Pursuant to Proposition 99, this measure would result in an additional tax on tobacco products at a rate equivalent to the new 50-cent per pack rate this measure would impose on cigarettes. This tax increase would be effective on July 1, 2003.

The effective tobacco products tax is currently based on the wholesale cost of these products at a tax rate that is equivalent to the rate of tax imposed on cigarettes. The rate is determined by dividing the tax rate per cigarette by the average wholesale cost per cigarette. For rate setting purposes, the average cost per cigarette for the 2002-03 fiscal year is \$0.1401. The current tax rate on cigarettes is \$0.0685 per cigarette. The tobacco tax rate for 2002-03 is 48.89 percent ( $\$0.0685 / \$0.1401 = 0.48894$ ).

For revenue estimation purposes, we assume no further increase in the wholesale cost of cigarettes in fiscal year 2003-04. The proposed tax rate on cigarettes would increase to \$0.0935 per cigarette for purposes of calculating the tobacco products tax rate (\$1.87 per pack, comprised of the current rate of \$1.37 per pack plus the rate increase of \$0.50 per pack;  $1.87 / 20 = 0.0935$ ).<sup>1</sup> This would increase the 2002-03 tobacco products tax rate to 66.74 percent ( $\$0.0935 / \$0.1401 = 0.6674$ ).

<sup>1</sup> The current effective rate of \$1.37 per pack for tobacco products consists of \$0.87 per pack related to Proposition 99 and \$0.50 related to Proposition 10.

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The wholesale cost of tobacco products was \$90.6 million during the 2000-01 fiscal year, down about 5 percent from 1999-00.<sup>2</sup> It would be reasonable to expect continued declines of 3 percent per year, similar to the long term trend for cigarette consumption. Using this assumption, estimated wholesale costs of tobacco products will be about \$82.7 million in fiscal year 2003-04 ( $\$90.6 \times 0.97 \times 0.97 \times 0.97 = \$82.7$ ).

However, an increase in the tax rate as large as the one proposed by this bill would surely cause both a decrease in actual consumption and an increase in tax evasion. Tax evasion is a larger problem with tobacco products than with cigarettes. Tax indicia, which are one disincentive to evaders, are not required for tobacco products. As mentioned earlier, at \$0.1401 per cigarette, the estimated wholesale cost of cigarettes would be \$2.80 per pack. Assuming a price elasticity of demand of  $-0.50$ , we would expect an additional decline of about 9 percent in tobacco products sales in 2003-04 resulting from the consumer behavior response to the tax increase ( $(\$0.50 / \$2.80) \times -0.50 = -0.089$ ). Although the exact magnitude of the effects is uncertain, we have assumed that this bill would cause a decrease of 9 percent. Therefore, the estimated wholesale cost of tobacco products subject to this proposal for fiscal year 2003-04 would be  $(\$82.7 \times 0.91 = \$75.3 \text{ million})$ .

The increase in tobacco products tax revenue for fiscal year 2003-04 would be as follows:

	Wholesale Cost (millions)	Rate	Revenue (millions)
Current Rate	\$82.7	48.89%	\$40.4
Proposed Rate	\$75.3	66.74%	<u>\$50.3</u>
Difference			\$9.9

### Sales and Use Tax Impacts

The total increase in excise tax revenues would be \$449.3 million for fiscal year 2002-03 and \$496.5 for fiscal year 2003-04. If all of these taxes are passed on to the ultimate consumer, there would be an increase in state and local sales and use tax revenue as follows:

	Increased Revenue	
	2002-03	2003-04
State (5%)	22.5	24.8
Local (2.25%)	10.1	11.2
Transit (0.67%)	3.0	3.3
Total	\$35.6 million	\$39.3 million

<sup>2</sup> Source: BOE Excise Taxes Division. Cited in a memo from Dave Hayes to Board Members, November 9, 2001, "Effects of Proposition 10 on Cigarette and Tobacco Products Consumption."

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**Revenue Summary**

Increasing the cigarette tax by fifty cents per pack and the resulting increase under Proposition 99 on tobacco products would result in the following revenue increase for the 2002-03 fiscal year and the 2003-04 fiscal year:

	<u>2002-03</u>	<u>2003-04</u>
Cigarette Tax Revenue Increase	\$ 417.3 million	\$ 486.6 million
Floor Stock Tax	\$ 33.0 million	0
Tobacco Tax Revenue Increase	0	\$ 9.9 million
State Sales & Use Tax ( at 5%)	\$ 22.5 million	\$ 24.8 million
 Total State	 \$ 472.8 million	 \$ 521.3 million
Local Sales & Use Tax (at 2.25%)	\$ 10.1 million	\$ 11.2 million
Transit Tax (at 0.67%)	\$ 3.0 million	\$ 3.3 million
 TOTAL	 \$ 485.9 million	 \$ 535.8 million

**Qualifying Remarks**

Other legislative proposals (SB 1700, SB 1701, and SB 1702) would require licensing of cigarette dealers and change stamping requirements, among other law changes. This revenue estimate assumes current law with respect to cigarette stamping requirements and licensing of persons who sell cigarettes and tobacco products.

Analysis prepared by:	Cindy Wilson	916-445-6036	07/22/02
Revenue estimate by:	Joe Fitz	916-323-3802	
Contact:	Margaret S. Shedd	916-322-2376	

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